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SBA

Business Basics

Understanding Money Sources

A Self-Instructional Booklet
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KEEP THIS GUIDE SHEET -- FOR INSTRUCTOR'S USE ONLY

UNDERSTANDING MONEY SOURCES
Instructor's Guide Sheet

This booklet contains:

1. Anticipating Capital Needs
2. Sources of Capital
3. Maximum Use of Internal Capital
4. Trade Credit -- Short Term Needs
5. Types of Debt Capital
6. Obligations of Debt Capital
7. Equity Capital Financing
8. Short- and Long-term Capital Sources
9. Accounts Receivable Financing
10. Collateral
11. Equity Investor Rights

Supplementary Instruction

Working with a small business, in which a need for capital has been identified:

1. Explore the various capital sources that should be pursued.

2. Consider cost control to restrict the need for capital, while improving profit generated from operations.

3. Consider the possibilities of prudent asset management to dispose of any unnecessary assets and convert other assets, such as receivables and inventory to cash more quickly, so that the need for added capital is minimized.

4. Establish a plan to permit the client to take full advantage of trade capital without jeopardizing credit status.

5. Identify various specific sources of debt and equity capital.

6. Identify collateral that can be used to secure loans.

7. Identify potential compensation to equity investors, such as opportunities for dividends, capital gains, or a future public offering that could attract equity capital.

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INTRODUCTION

Never enough money! How many times have you said that. You need capital to get sales, buy inventory, pay your employees, purchase assets, pay taxes, you name it you need money for it. Your need for capital is a continuing one. To just stay in business or to expand, the small business owner needs capital, but where do you get it?

Expansion opportunities or a chance to purchase cost-saving equipment can also create a need for extra capital.

Available Sources

In order to secure the capital they need, small business owners must understand the various sources of money that are available to them such as the following:

- Capital generated internally.
- Capital available from trade creditors.
- Borrowed money.
- Sale of an ownership interest in the business to equity investors.

Each of these capital sources has unique characteristics. These characteristics must be fully understood by the small business owner so that he or she will know what sources are available and which source is best suited to the needs of the business.

Booklet Objectives

This booklet has been designed to help the small business owner in the following ways:

- Recognize those situations that create a need for additional capital.
- Identify the capital sources that are available to the small business owner.
- Manage the business judiciously to take full advantage of the capital that can be generated internally.

- Establish a plan to permit the client to take full advantage of trade capital without jeopardizing credit status.
- Identify various specific sources of debt and equity capital.
- Identify collateral that can be used to secure loans.
- Identify potential compensation to equity investors such as opportunities for dividends, capital gains, or a future public offering that could attract equity capital.

HOW THE NEED FOR CAPITAL ARISES

There is more than one way to skin a cat. You'd better remember this old adage when your business needs more inventory, personnel, and facilities. As your business grows, so does your need for more and more capital. Remember there is more than one way and more than one place to raise the money you need.

Causes of Additional Capital Needs

There are many factors that can create a need for additional capital. Some of the more common are as follows:

- Sales growth requires inventories to be built to support the higher sales level.
- Sales growth creates a larger volume of accounts receivable.
- Growth requires the business to carry larger cash balances in order to meet its current obligations to employees, trade creditors, and others.
- Expansion opportunities such as a decision to open a new branch, add a new product, or increase capacity.
- Cost savings opportunities such as equipment purchases that will lower production costs or reduce operating expenses.
- Opportunities to realize substantial savings by taking advantage of quantity discounts on purchases for inventory, or building inventories prior to a supplier's price increase.
- Seasonal factors, where inventories must be built before the selling season begins and receivables may not be collected until 30 to 60 days after the selling season ends.
- Current repayment of obligations or debts may require more cash than is immediately available.
- Local or national economic conditions which cause sales and profit to decline temporarily.
- Economic difficulties of customers that can cause them to pay more slowly than expected.
- Failure to retain sufficient earnings in the business.
- Inattention to asset management may have allowed inventories or accounts receivable to get out of hand.

Combination

Frequently, the cause cannot be entirely attributed to any one of these factors, but results from a combination. For example, a growing, apparently successful business may find that it does not have sufficient cash on hand to meet a current debt installment or to expand to a new location because customers have been slow in paying.

NOTE: Cover the correct answers and write your answers on a separate piece of paper (or in the book). Check your answers and review weak areas. Do all the exercises the same way.

1. Sales increases ordinarily lead to increases in accounts receivable. (TRUE/FALSE)

TRUE

---

2. Sales increases generally require increased inventories. (TRUE/FALSE)

TRUE

---

3. If a business expects its sales and operating expenses to increase in the coming year, it can also expect its minimum cash balance requirement to (INCREASE/DECREASE).

INCREASE

---

4. A business may need additional capital to acquire fixed assets that could increase productive capacity or offer _____ opportunities.

---

cost savings

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5. Which of the following businesses would probably have a seasonal need for extra capital?

   a. a manufacturer of ski equipment
   b. a hardware store
   c. a wholesaler of industrial machinery

---

   a. a manufacturer of ski equipment

---

6. Name two reasons why a business might plan unusually large purchases of inventory:

   1.
   2.

   To take advantage of quantity discounts.
   To build inventories prior to a supplier's price increase.

---

7. How could a business' cash position be affected by its customers' economic conditions?

   Customers may pay more slowly than usual.

---

8. A consistently profitable business pays out all of its earnings each year to compensate its investors. How can this weaken its capital position?

   Failure to retain sufficient earnings.

READEX FICHE

9. A business neglects its inventory controls, credit policies, and collection procedures. This could result in a need for additional capital due to poor _____ management.

---

asset

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10. The need for capital can always be attributed to one of the factors listed previously. (TRUE/FALSE)

FALSE (The need can arise due to a combination of factors.)

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* * * * *

Short- and Long-Term Capital

Capital needs can be classified as either short- or long-term. Short-term needs are generally those of less than one year. Long-term needs are those of more than one year.

Short-term Financing

Short-term financing is most common for assets that turn over quickly such as accounts receivable or inventories. Seasonal businesses that must build inventories in anticipation of selling requirements and will not collect receivables until after the selling season often need short-term financing for the interim. Contractors with substantial work-in-process inventories often need short-term financing until payment is received. Wholesalers and manufacturers with a major portion of their assets tied up in inventories and/or receivables also require short-term financing in anticipation of payments from customers.

Long-term Financing

Long-term financing is more often associated with the need for fixed assets such as property, plant, and equipment where the assets will be used in the business for several years. It is also a practical alternative in many situations where short-term financing requirements recur on a regular basis.

Recurring Needs

A series of short-term needs could often be more realistically viewed as a long-term need. The addition of long-term capital should eliminate the short-term needs and the crises that could occur if capital were not available to meet a short-term need.

Steady Growth

Whenever the need for additional capital grows continually without any significant pattern, as in the case of a company with steady sales and profit from year to year, long-term financing is probably more appropriate.

* * * * *

1. Capital requirements of less than one year are usually referred to as _____-term.

---

short

---

2. The more common need for extra capital in a business with a distinct seasonal pattern would ordinarily be (SHORT/LONG)-term.

SHORT

---

3. Under what circumstances could a seasonal requirement become a long-term capital requirement?

When the seasonal need recurs frequently.

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4. In a business that shows steady sales and profit growth from year to year, the more practical approach to securing needed capital is through _____-term sources.

---

long

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5. Financing of fixed assets would generally be considered a need for _____-term capital.

---

long

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* * * * *

INTERNAL FINANCING SOURCES

Internal vs. External

Internal sources of capital are those generated within the business. External sources of capital are those outside the business such as suppliers, lenders, and investors.

For example, a business can generate capital internally by accelerating collection of receivables, disposing of surplus inventories, retaining profit in the business, or cutting costs.

Capital can be generated externally by borrowing or locating investors who might be interested in buying a portion of the business.

Internal Financing Sources

Before seeking external sources of capital from investors or lenders, a business should thoroughly explore all reasonable sources for meeting its capital needs internally. Even if this effort fails to generate all of the needed capital, it can sharply reduce the external financing requirement, resulting in less interest expense, lower repayment obligations, and less sacrifice of control. With a lower requirement, the business' ability to secure external financing will be improved. Further, the ability to generate maximum capital internally and to control operations will enhance the confidence of outside investors and lenders. With more confidence in the business and its management, lenders and investors will be more willing to commit their capital.

* * * * *

1. The first sources of capital that should be explored are (INTERNAL/EXTERNAL).

INTERNAL

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2. A loan from a bank is an (INTERNAL/EXTERNAL) source.

EXTERNAL

---

3. Generating cash through accelerated collection of money owed to the business is an example of an (INTERNAL/ EXTERNAL) source.

INTERNAL

---

4. If a business cannot generate sufficient capital internally, it should utilize external sources for its entire requirement. (TRUE/FALSE)

FALSE

---

5. Taking full advantage of internal sources before using external sources for any additional funds requirement:

   a. is usually unnecessary
   b. reduces the amount that must be raised externally

---

   b. reduces the amount that must be raised externally

---

6. A business reduces its need for borrowing by fully utilizing internal capital sources. As a result, which of the following will probably occur?

   a. It will incur less interest expense.
   b. Debt repayment will be lower.
   c. Neither of the above.
   d. Both of the above.

---

   d. Both of the above.

---

7. As a business lowers the amount that it wishes to borrow, its chances of securing the loan (INCREASE/DECREASE).

INCREASE

---

8. A lender or investor will probably have more confidence in a business that takes full advantage of internal capital sources before looking outside. (TRUE/FALSE)

TRUE

---

9. Identify the external sources of capital on the list below:

   a. trade creditors (suppliers to whom money is owed)
   b. bankers and other lenders
   c. investors
   d. disposal of surplus inventories

---

   a. trade creditors (suppliers to whom money is owed)
   b. bankers and other lenders
   c. investors

---

* * * * *

Basic Sources

Basically, there are three principal sources of internal capital. These are as follows:

. Increasing the amount of earnings kept in the business.

. Prudent asset management.

. Cost control.

Increased Earnings Retention

Many businesses are able to meet all of their capital needs through earnings retention. Each year, shareholders' dividends or partners' drawings are restricted so that the largest reasonable share of earnings is retained in the business to finance its growth.

As with other internal capital sources, earnings retention not only reduces any external capital requirement, but also affects the business' ability to secure external capital. Lenders are particularly concerned with the rate of earnings retention, since the ability to repay debt obligations normally depends upon the amount of cash generated through operations. If this cash is used excessively to pay dividends or to permit withdrawals by investors, the company's ability to meet its debt obligations will be threatened.

Asset Management

Many businesses have non-productive assets that can be liquidated (sold or collected) to provide capital for short-term needs. A vigorous campaign of collecting outstanding receivables, with particular emphasis on amounts long outstanding, can often produce significant amounts of capital. Similarly, inventories can be analyzed and those goods with relatively slow sales activity or with little hope for future fast movement can be liquidated. The liquidation can occur through sales to customers or through sales to wholesale outlets, as required.

Fixed assets can be sold to free cash immediately. For example, a company automobile might be sold and provide cash of $2,000 or $3,000. Owners and employees can be compensated on an actual mileage basis for use of their personal cars on company business. Or if an automobile is needed on a full-time basis, a lease can be arranged so that a vehicle will be available.

Other assets such as loans made by the business to officers or employees, investments in non-related businesses, or prepaid expenses should be analyzed closely. If they are non-productive, they can often be liquidated so that cash is available to meet the immediate needs of the business.

Any of the above steps can be taken to alleviate short-term cash shortages.

On a long-term basis, the business can minimize its external capital needs by establishing policies and procedures that will reduce the possibility of cash shortages caused by ineffective asset management. These policies could include the establishment of more rigorous credit standards, systematic review of outstanding receivables, periodic analysis of slow-moving inventories, and establishment of profitability criteria so that fixed asset investments are more closely controlled.

Cost Reduction

Careful analysis of costs, both before and after the fact, can improve profitability and therefore the amount of earnings available for retention. At the same time, cost control minimizes the need for cash to meet obligations to trade creditors and others.

Before the fact, a business can establish buying controls that require a written purchase order and competitive bids on all purchases above a specified amount. Decisions to hire extra personnel, lease additional space, or incur other additional costs can be reviewed closely before commitments are made.

After the fact, management should review all actual costs carefully. Expenses can be compared with objectives, experience in previous periods, or with other companies in the industry. Whenever an apparent excess is identified, the cause of the excess should be closely explored and corrective action taken to prevent its recurrence.

* * * * *

1. The three principal sources of internal capital are increased retention of _____, prudent management of _____, and close control of _____.

---

earnings
assets
costs

---

2. Restricting partners' drawings or shareholders' dividends:

   a. controls costs
   b. increases retained earnings
   c. both of the above

---

   b. increases retained earnings

---

3. Short-term capital needs can often be met quickly through _____ of non-productive assets.

---

   liquidation

---

4. On a longer-term basis, internal capital generation can be accelerated through the establishment of _____ and _____ that will improve the effectiveness of asset management.

---

   policies
   procedures

---

5. Establishment of sound credit policies and collection procedures is more useful in improving the generation of capital on a (LONG/SHORT)-term basis.

   LONG

---

6. Cost control increases the rate at which capital is generated internally by:

   a. increasing the amount of earnings available for retention

   b. reducing commitments to suppliers and others

   c. both of the above

---

   a. increasing the amount of earnings available for retention

---

7. Establishing purchasing policies is an example of cost control (BEFORE/AFTER) the fact.

   BEFORE

---

8. Review and evaluation of actual expenses is an example of cost control (BEFORE/AFTER) the fact.

   AFTER

---

9. Which of the following assets should be considered for liquidation to generate cash internally?

   a. inventories needed to sustain sales
   b. past-due receivables
   c. an amount owed by an employee

---

   b. past-due receivables
   c. an amount owed by an employee

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10. A company decides to sell productive machinery in order to free cash. How can it continue to enjoy the services of the machine?

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leasing

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* * * * *

Trade Credit

Trade credit is credit extended by suppliers. Ordinarily, it is the first source of extra capital that the small business owner turns to when the need arises.

Informal Extensions

Frequently, this is done with no formal planning by the business. Suppliers' invoices are simply allowed to "ride" for another 30 to 60 days. Unfortunately, this can lead to a number of problems. Suppliers may promptly terminate credit and refuse to deliver until the account is settled, thus denying the business access to sorely needed supplies, materials, or inventory. Or, suppliers might put the business on a C.O.D. basis, requiring that all shipments be fully paid in cash immediately upon receipt. At a time when a business is obviously strapped for cash, this requirement could have the same effect as cutting off deliveries altogether.

Planning Advantages

A planned program of trade credit extensions can often help the business secure extra capital that it needs without recourse to lenders or equity investors. This is particularly true whenever the capital need is relatively small or short in duration.

A planned approach should involve the following:

- Take full advantage of available payment terms. If no cash discount is offered and payment is due on the 30th day, do not make any payments before the 30th day.

- Whenever possible, negotiate extended payment terms with suppliers. For example, if a supplier's normal payment terms are net 30 days from the receipt of goods, these could be extended to net 30 days from the end of the month. This effectively "buys" an average of 15 extra days.

- If the business feels that it needs a substantial increase in time, say 60 to 90 days, it should advise suppliers of this need. They will often be willing to accept it, provided that the business is faithful in its adherence to payment at the later date.

. Consider the effect of cash discounts and delinquency penalties for late payment. Frequently, the added cost of trade credit may be far more expensive than the cost of alternate financing such as a short-term bank loan.

. Consider the possibility of signing a note for each shipment, promising payment at a specific later date. Such a note, which may or may not be interest-bearing, would give the supplier evidence of your intent to pay and increase the supplier's confidence in your business.

Ready Availability

Trade credit is often available to businesses on a relatively informal basis without the requirements for application, negotiation, auditing, and legal assistance often necessary with other capital sources.

Usage

Trade credit must be used judiciously. Its easy availability is particularly welcome in brief periods of limited needs. Used imprudently, however, it can lead to curtailment of relations with key suppliers and jeopardize your ability to locate other, competitive suppliers who are willing to extend credit to your business.

* * * * *

1. Credit available from your suppliers is called _____ credit.

---

trade

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2. As with bank loans and other capital sources, trade credit always requires formal application and negotiation. (TRUE/FALSE)

FALSE

---

3. Since formal application and negotiation is not always required, no planning is needed to take advantage of trade credit. (TRUE/FALSE)

FALSE

---

4. Trade credit is a particularly useful capital source when the need is relatively (SMALL/LARGE) and will last for a relatively (SHORT/LONG) period.

SMALL
SHORT

---

5. Which of the following could occur if a business abuses its trade credit privilege?

   a. Suppliers could refuse to deliver.

   b. The business could be put on a C.O.D. basis.

   c. The business may be unable to secure credit from competitive suppliers.

   d. All of the above.

---

d. All of the above.

---

6. The first step in a planned approach to utilizing trade credit is to take full advantage of available payment _____.

---

terms

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7. In many cases, payment terms can be negotiated so that the business can enjoy a longer payment period. (TRUE/FALSE)

TRUE

---

8. Forfeiture of cash discounts and the incurrence of delinquency penalties can be costly. (TRUE/FALSE)

TRUE

---

9. If you are temporarily unable to pay your suppliers in less than 60 or 90 days, you are better advised to:

   a. say nothing and pay what you can when you can

   b. advise the supplier when you can pay and be certain to make payment on that date

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   b. advise the supplier when you can pay and be certain to make payment on that date

---

10. Evidence of your willingness to pay at a specific later date can be provided by a signed _____.

---

note

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* * * * *

Debt Capital

Debt capital is an amount of money borrowed from a creditor. The amount borrowed is usually evidenced by a note, signed by the borrower, agreeing to repay the principal amount borrowed plus interest on some predetermined basis.

Borrowing Term

The terms under which money is borrowed may vary widely. Short-term notes can be issued for periods as brief as 10 days to fill an immediate need. Long-term notes can be issued for a period of several years.

Payment Schedule

When the terms of a debt are negotiated, a payment schedule is established for both interest obligations and principal repayment.

Discounted Notes

In some cases, particularly in short-term borrowing, the total amount of interest due over the term of the note is deducted from the principal before the proceeds are issued to the borrower. Such a note is called a discounted note.

Short-term Borrowing

Short-term borrowing usually requires repayment within 60 to 90 days. Notes are often renewed, in whole or in part, on the due date, provided that the borrower has lived up to the obligations of the original agreement and the business continues to be a favorable lending risk.

Availability

Commercial banks are the ordinary source of short-term loans for small businesses.

Credit Lines

When a business has established itself as being worthy of short-term credit, and the amount needed fluctuates from time to time, banks will often establish a line of credit with the business. The line of credit is the maximum

amount that the business can borrow at any one time. The exact amount borrowed can vary according to the needs of the business but cannot exceed its established credit line.

These arrangements give the business access to its requirements up to the credit limit, or line. However, it pays interest only on the actual amount borrowed, not the entire line of credit available to it.

* * * * *

1. Amounts borrowed from lenders are (DEBT/EQUITY) capital.

DEBT

---

2. The amount borrowed is called the _____.

---

principal

---

3. In a loan agreement, the borrower is required to repay the _____ of the loan plus _____ on the amount owed.

---

principal
interest

---

4. Loans are usually evidenced by a promissory _____ signed by the borrower.

---

note

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5. Debt can be either long- or _____-term.

---

short

---

6. Notes due within one year are considered (SHORT/LONG)-term.

SHORT

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7. When due, a short-term note:

   a. must always be repaid in full
   b. may be renewed, under certain circumstances
   c. is automatically renewed

---

b. may be renewed, under certain circumstances

---

8. A short-term note in which the entire interest due is deducted from the face amount before the proceeds are issued to the borrower is called a _____ note.

---

discounted

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9. Short-term loans are usually available to small businesses from _____.

---

commercial banks

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10. An agreement under which a business can borrow varying amounts on an "as needed" basis is called a _____.

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credit line

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11. The credit line is the (MAXIMUM/AVERAGE) amount that the business can borrow under such an arrangement.

MAXIMUM

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12. With a credit line, the business pays interest on:

    a. the actual amount borrowed
    b. the entire line, whether or not it is actually used

---

a. the actual amount borrowed

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* * * * *

Long-term Debt

Long-term debt is borrowing for a period greater than one year. This general classification includes "intermediate debt" which is borrowing for periods of one to 10 years.

Small Business Applications

For small businesses, borrowed capital for periods greater than 10 years is usually available only on real estate mortgages. Other long-term borrowing usually falls into the "intermediate" classification and is available for periods up to 10 years. Such loans are called "term loans."

Mortgage Payment Schedules

Principal and interest payments on mortgages usually involve uniform monthly payments that include both principal and interest.

Each successive monthly payment reduces the amount of principal outstanding. Therefore, the amount of interest owed decreases and the portion of the monthly payment applicable to principal

increases. In the early years of a mortgage, the portion of the monthly payment applied against the principal is relatively small, but grows with each payment.

Term Loan Payment Schedules

For term loans, payment of principal and interest is ordinarily scheduled on an annual, semiannual, or quarterly basis. For example, a 5-year, $50,000 term note bearing 10% interest might have the following payment schedule specified in the note agreement:

End of Year	Principal Repayment	Principal Outstanding	Interest Payment @ 10%
1	$10,000	$50,000	$5,000
2	10,000	40,000	4,000
3	10,000	30,000	3,000
4	10,000	20,000	2,000
5	10,000	10,000	1,000

Repayment Schedules

The dates on which principal and interest payments are due should be scheduled carefully. For example, a manufacturer with heavy sales just before Christmas and receivables collections through January might best be able to schedule repayments in February. If a payment were due in October or November, when inventories were high and receivables were climbing, the payment could be crippling.

* * * * *

1. Long-term debt is considered amounts borrowed for periods longer than:

    a. 30 days
    b. one year
    c. 20 years

---

    b. one year

---

2. Amounts borrowed for periods of five to 10 years are called _____ loans.

---

term

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3. Borrowing for periods greater than 10 years is usually available to small businesses only on _____.

---

real estate mortgages

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4. Real estate mortgage payments are ordinarily scheduled on a:

   a. uniform monthly basis
   b. declining annual basis
   c. level annual basis

---

a. uniform monthly basis

---

5. The amount of the uniform monthly mortgage payment applicable to interest is (HIGHER/LOWER) in the early years of the mortgage.

HIGHER

---

6. As the portion of the uniform payment applied to interest decreases, the portion applied to principal repayment (INCREASES/DECREASES).

INCREASES

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7. Principal and interest payments on term loans are established on a schedule that is:

   a. specified by law
   b. negotiated by the parties

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   b. negotiated by the parties

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* * * * *

Collateral

Loans may be secured or unsecured. In a secured loan, the borrower pledges certain assets as collateral (security) to protect the lender in case of default on the loan or failure of the business. If the business defaults on the loan through failure to meet interest obligations or principal repayments, the noteholder (lender) assumes ownership of the collateral. If the business fails, the noteholder claims ownership of those specific assets pledged as collateral before the claims of other creditors are settled.

Typical Collateral

In long-term borrowing, fixed assets such as real estate or equipment are usually pledged as collateral.

For short-term borrowing, inventories or accounts receivable are the usual collateral.

* * * * *

1. A loan in which the borrower pledges certain assets as a guarantee of payment is a(n) (SECURED/UNSECURED) loan.

   SECURED

---

2. If a business defaults on a secured loan, the lender becomes the owner of the collateral. (TRUE/FALSE)

TRUE

---

3. If a business fails with a secured loan outstanding, the lender has a:

   a. specific claim against those assets pledged as collateral

   b. general claim against all assets of the business, just like any other creditor

---

   a. specific claim against those assets pledged as collateral

---

4. For long-term loans, the most common collateral is (FIXED/CURRENT) assets.

FIXED

---

5. The most common collateral for short-term loans are _____ and _____.

---

accounts receivable
inventories

---

* * * * *

Inventory Financing

Inventory financing is most commonly used in automobile and appliance retailing. As each unit is purchased by the retailer, the manufacturer is paid by the lender. The lender is repaid by the retailer when the unit is sold. Interest is determined separately for each unit, based upon the actual amount originally paid by the lender and the period

between the time the money is paid and the lender is reimbursed by the retailer.

Accounts Receivable Financing

Basically, accounts receivable financing falls into two categories as follows:

- Assignments. The business pledges, or "assigns," its receivables as collateral for a loan.
- Factoring. The borrower sells its accounts receivable to a lender ("factor").

Although these arrangements are not loans, in a pure sense, the effect is the same.

Receivables Assignments

When receivables are assigned, the amount of the loan varies according to the volume of receivables outstanding. Normally, the lender will advance some specified percentage of the outstanding accounts receivable up to a specific credit limit. For example, look at the schedule below. The company can borrow up to 80% of assigned receivables, up to a maximum of $100,000.

Accounts Receivable	Amount Borrowed
$100,000	$ 80,000
125,000	100,000
150,000	100,000

On the first line, accounts receivable are $100,000 and the amount loaned is 80% of $100,000, or $80,000.

On the second line, outstanding receivables are $125,000. The amount loaned increases to $100,000 ($125,000 x 0.80).

On the third line, accounts receivable are $150,000. Eighty percent of this amount would be $120,000. However, this exceeds the established limit of $100,000. Therefore, borrowing is restricted to the $100,000 limit.

In many industries, accounts receivable financing is considered a sign of weakness. However, it is quite common in others. This is particularly true in the garment industry and in personal finance companies.

When customers must pay invoices directly to a factor, it may create doubts about the company's financial stability and, therefore, its ability to deliver.

When accounts receivable are assigned, the borrower is still responsible for collection. Upon collection of any receivable, the amount borrowed should be repaid. Interest is based upon the amount borrowed and the time between receipt of proceeds by the borrower and repayment.

Factoring Accounts Receivable

When accounts receivable are factored, they are sold to the factor and the borrower has no responsibility for collection. The borrower pays the factor a service charge based upon the amount of each receivable sold. In addition, the borrower pays interest for the period between the sale of the receivable and the date the customer pays the factor.

Since the factor is responsible for collection, it will only purchase those receivables for which it has approved credit.

* * * * *

1. A loan agreement in which the business pledges its accounts receivable as collateral (security) for a loan is called:

   a. an assignment of accounts receivable
   b. factoring

---

   a. an assignment of accounts receivable

---

2. In a factoring arrangement, the borrower:

   a. pledges its receivables as security
   b. sells its receivables to the factor

---

   b. sells its receivables to the factor

---

3. When accounts receivable are assigned, the lender usually accepts all receivables and will loan funds up to their full value. (TRUE/FALSE)

FALSE

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4. A lender agrees to loan 75% of assigned receivables with a maximum line of $75,000. How much could the business borrow by assigning $80,000 of receivables? $_____

$60,000 ($80,000 x 0.75)

---

5. How much could the business borrow by assigning $100,000 of receivables? $_____

$75,000 ($100,000 x 0.75)

---

6. How much could the business borrow by assigning $120,000 of receivables? $_____

$75,000 ($120,000 x 0.75 = $90,000, <u>but</u> the limit is $75,000)

---

7. When accounts receivable are assigned, the (BORROWER/LENDER) is responsible for collection.

BORROWER

---

8. When accounts receivable are factored, the (BUSINESS/FACTOR) is responsible for collection.

FACTOR

---

9. In factoring arrangements, the business pays interest plus a _____ charge.

---

service

---

10. A factor must approve a customer's credit before it will accept receivables from the customer. (TRUE/FALSE)

TRUE

---

11. In some industries, accounts receivable financing is considered a sign of weakness. (TRUE/FALSE)

TRUE

---

* * * * *

Unsecured Debt

The secured creditor's risk is reduced by the claim against specific assets of the business. In default or liquidation, the secured creditor can take possession of these assets to recover any unpaid amounts due from the business.

Holders of unsecured notes do not enjoy the same protection. If the company defaults on a payment, the unsecured creditor, under normal circumstances, can only renegotiate the amount due, perhaps by seeking collateral, or force the company to liquidate. In liquidation, the holder of an unsecured note

would normally have no rights that are superior to those of any other creditors.

Restriction on Business

Therefore, when accepting an unsecured note, the lender will often place certain restrictions on the business. A typical restriction might be to prevent the company from incurring any debt with a prior claim on the assets of the business in the event of default or failure. For example, a term note agreement might prevent a company from financing its receivables or inventories since this would result in a prior claim against the assets of the business in liquidation.

Such restrictions may have no effect on the business' ability to operate. However, in other cases, such restrictions could be severe. For example, a business may have a chance to sell to a major new customer. The new customer may insist upon 60-day credit terms which will require the business to seek additional external financing. Normally, this financing might be readily available on realistic terms from a factor. However, the restriction of the unsecured note could prevent the business from taking advantage of this significant opportunity for sales and profit improvement.

Personal Guarantees

The liability of a corporation's shareholders is generally limited to the assets of the business. Creditors have no normal claim against the personal assets of the stockholders if the business should fail. Therefore, many lenders, when issuing credit to small corporations, seek the added protection of a personal guarantee by the owner (or owners). This protects the creditors if the business fails, since they retain a claim against the personal assets of the owners to fulfill the debt obligation.

Interest Rates

The interest rates at which small businesses borrow are relatively high. Banks and other commercial lending institutions normally reserve their lowest available interest rate, the so-called prime rate, for those low-risk situations such as short-term loans for major corporations and public agencies where the chances of default are slim and the costs for collection, credit search, and other administrative tasks are minimal. Because of the higher risks involved in loaning to small businesses, lenders often seek greater collateral while charging higher interest rates to offset their added costs of credit search and loan administration.

* * * * *

1. In liquidation, the holder of an unsecured note (DOES/ DOES NOT) have a claim against specific assets.

DOES NOT

---

2. In liquidation, the holder of an unsecured note would normally have a claim that takes priority over the claims of other creditors. (TRUE/FALSE)

FALSE

---

3. As protection, the unsecured noteholder will often place certain _____ upon the business' ability to borrow further capital.

---

restrictions

---

4. How can these restrictions prove deleterious to the company's best interests?

By preventing it from securing additional debt to finance potentially profitable opportunities.

---

5. Why do holders of unsecured notes insist upon restrictions?

To reduce their risk.

---

6. If the owners of a business personally guarantee a note and the business should liquidate, the noteholder (WOULD/ WOULD NOT) have a claim against their personal assets.

WOULD

---

7. Major corporations usually borrow at the _____ rate. Small businesses usually borrow at a (HIGHER/ LOWER) rate.

---

prime
HIGHER

---

8. Give two reasons why small businesses pay higher interest rates than major corporations:

1.
2.

Greater risk.
Higher costs of administration.

---

* * * * *

Equity Capital

Unlike debt capital, equity capital is permanently invested in the business. The business has no legal obligation for repayment of the amount invested or for payment of interest for the use of the funds.

Share of Ownership

The equity investor shares in the ownership of the business and is entitled to participate in any distribution of earnings through dividends, in the case of corporations, or drawings, in the case of partnerships.

The extent of the equity investor's participation in the distribution of earnings of a corporation depends upon the number of shares held. In a partnership, the equity investor's participation will depend upon the ownership percentage specified in the partnership agreement.

Voting Rights

The equity investor's ownership interest also carries the right to participate in certain decisions affecting the business.

Legal Liability

The personal liability of equity investors for debts of the business depends upon the legal form of the organization. Basically, the investor who acquires equity in a partnership could be personally liable for debts of the business if the business should fail. In a corporation, the liability of equity investors (snareholders) is limited to the amount of their investment.

In other words, if a partnership should fail, creditors could have a claim against the personal assets of the individual partners. If a corporation should fail, the only claims of creditors would be against any remaining assets of the corporation, not against any personal assets of the shareholders.

* * * * *

1. The business has a legal obligation to repay the capital received from equity investors. (TRUE/FALSE)

FALSE

---

2. Equity investors are entitled to interest payments at a predetermined rate. (TRUE/FALSE)

FALSE

---

3. Equity investors participate in any distribution of earnings through dividends or drawings. (TRUE/FALSE)

TRUE

---

4. Earnings distributions in corporations are called (DIVIDENDS/DRAWINGS).

DIVIDENDS

---

5. Earnings distributions in partnerships are called _____.

---

drawings

---

6. Equity investors are ordinarily entitled to a voice in the conduct of the business' affairs. (TRUE/FALSE)

TRUE

---

7. In a partnership, an equity investor may be personally liable for unsatisfied debts of the business. (TRUE/FALSE)

TRUE

---

8. In a corporation, equity investors are personally liable for unsatisfied debts of the business. (TRUE/FALSE)

FALSE

---

9. Evidently, the equity investor's risk is greater when acquiring an interest in a (CORPORATION/PARTNERSHIP).

PARTNERSHIP

---

* * * * *

Equity Investor's Compensation

The purchaser of an equity interest in a business expects to be compensated for the investment in any of the three following ways:

. Income from earnings distribution of the business, either as dividends paid to corporate shareholders or as drawings in a partnership.

. Capital gain realized upon sale of the business.

. Capital gain realized from selling his or her interest to other partners.

Capital Gains

Capital gain is the term used to describe any excess of the selling price of an investment over the initial purchase price. For example, if you purchased an equity interest in a business for $5,000 and later sold it for $8,000, you wuld realize a capital gain of $3,000 ($8,000 - $5,000).

Tax Advantages

Long-term capital gains are those realized on investments held for a period longer than six months. These gains are subject to federal income tax at an effective rate equal to one-half of the investor's tax rate on ordinary income. Therefore, income tax advantages are often a major cause of the investor's desire to acquire an equity interest.

Earnings Distribution

The equity investor in a partnership is entitled to a share of all drawings paid out to partners at a percentage established when the interest was purchased. For example, assume an investor acquired a 20% interest in a partnership. The distribution of earnings to all partners in a given year is $20,000. The holder of the 20% interest would receive $4,000 ($20,000 x 0.20).

The dividends received by the equity investor in a corporation depend upon the number of shares held. For example, if a corporation voted a dividend of $1.50 per share in a given year, the owner of 1,000 shares would receive a dividend of $1,500 (1,000 x $1.50).

Sale (or Liquidation) of Business

If a business is sold or liquidated, the equity investor shares in the distribution of the proceeds. As with an earnings distribution, the share of the proceeds in a corporation sale depends upon the number of shares held. In a partnership, each partner's share of the proceeds is based upon the percentages specified in the partnership agreement.

If the proceeds received by the equity investor exceed the original purchase price, this excess is considered a capital gain and taxed accordingly at effective rates more favorable than those for ordinary income.

If the business were liquidated, the assets would be sold and the proceeds would first be used to discharge any outstanding obligations to creditors. The balance of the proceeds, after

these obligations had been fulfilled, would be distributed to the equity investors in accordance with their shareholdings or percentages of interest.

Sale of Equity Interest

As a business prospers and grows, the value of an equity interest grows with it. Therefore, the equity investor may be able to sell his or her interest at a price higher than the initial acquisition cost.

For example, an equity investor in a corporation may have purchased his or her interest at $10.00 per share. As the business grows, he or she is able to sell the shares at $15.00 per share, realizing a capital gain of $5.00 ($15.00 - $10.00) on each share sold.

Capital Gains vs. Dividends

In many cases, the equity investor in a small business is primarily interested in capital gains. Aside from the tax advantages described earlier, the equity investor usually realizes that the earnings of the small business are better retained in the business than distributed as dividends or drawings. Retention of earnings permits the business to grow so that the value of the equity interest increases. The investor can realize a return on the investment through a capital gain derived from selling his or her shares or upon sale of the business.

* * * * *

1. The purchaser of shares in a small corporation is only interested in the potential dividend income. (TRUE/FALSE)

FALSE

---

2. An amount earned from selling an investment at a price higher than its original cost is called a _____.

---

capital gain

---

3. A long-term capital gain requires that the investment be held for a period of at least:

   a. 6 months
   b. one year
   c. 20 years

---

   a. 6 months

---

4. The tax rate on long-term capital gains is (MORE/LESS) favorable than the tax rate on ordinary income.

   MORE

---

5. The effective tax rate on long-term capital gains is _____% of the rate on ordinary income.

   50%

---

6. Identify two ways that the equity investor in a small business can realize a capital gain:

   1.
   2.

   Distribution of the proceeds from the sale of the business.

   Sale of the equity interest to another party.

---

7. In a partnership, the equity investor's share of any drawings by partners is determined:

   a. by the amount invested

   b. by the number of shares held

   c. according to the percentages specified in the partnership agreement

---

   c. according to the percentages specified in the partnership agreement

---

8. In a corporation, the equity investor's participation in any dividends paid by the corporation is determined:

   a. by the amount invested

   b. by the number of shares held

   c. according to percentages specified in the partnership agreement

---

   b. by the number of shares held

---

9. Usually, equity investors in small businesses are interested in:

   a. dividends or drawings
   b. capital gains

---

   b. capital gains

---

10. Retention, rather than distribution, of earnings is likely to help the business prosper and grow, increasing the value of the equity investment and the opportunity for realizing a capital gain. (TRUE/FALSE)

TRUE

---

* * * * *

Public Stock Offerings

When businesses are first organized, equity capital is usually secured from a combination of sources such as the original owners' personal savings and through solicitations from friends, relatives, or other persons known to have financial capability for such investments.

As the need for equity capital becomes greater, say $50,000 to $200,000, it is customary to seek capital through the services of professional finders, who receive a fee for securing the capital needed. These finders normally have access to wealthy individuals, capital management companies, estates, trusts, and others with sufficient capital to make such an investment.

At higher levels of capital need, shares are sold through public offerings. The public offering seeks to attract a large number of investors to purchase stock, in large or small amounts. A market is then created for the stock. Shares purchased by the public, as well as the shares held by the original owners, and any subsequent equity investors can also be sold at the going market price. These transactions do not have a direct effect on the business' capital position since it does not receive the proceeds from the sale.

The equity investor can realize a capital gain by selling shares at prices higher than the original purchase price.

Risks of Equity Investment

The equity investor assumes substantial risk. Unlike the secured creditor, the equity investor has no specific claim against any assets of the business. In liquidation, all claims of all creditors must be satisfied before any remaining assets become available for distribution to the owners. Even then, the equity investor's participation in the proceeds is restricted to a share that is proportionate to the number of shares held or the partnership interest.

Since the risks of equity investment are so substantial, particularly in the case of small businesses, equity investors expect a considerably higher return than the lender.

A lender might be willing to loan money to a business at an interest rate of 10% or 12% since it has certain legal protections in the event of default or liquidation. The investor of equity capital in the same business might seek a far higher return, perhaps 20%, 50%, or even more in order to compensate for the added risk of equity investment.

* * * * *

1. An equity investor's participation in the proceeds from the sale or liquidation of a corporation is determined by:

   a. the amount of the original investment
   b. the number of shares held

---

   b. the number of shares held

---

2. If a business were liquidated, the equity investors would share in the distribution of any proceeds from the sale of the assets:

   a. in proportion with the creditors
   b. after all obligations to creditors have been discharged

---

   b. after all obligations to creditors have been discharged

---

3. Since the claims of creditors precede those of equity investors in liquidation, the equity investor is exposed to a higher risk. (TRUE/FALSE)

   TRUE

---

4. In a public stock offering, the business attempts to attract:

   a. a single large investor
   b. a large number of investors

---

   b. a large number of investors

---

5. The earnings expectations of equity investors are usually higher than the interest rates asked by lenders. (TRUE/FALSE)

   TRUE

---

6. Name three ways in which equity investors may be compensated for their capital:

   1.
   2.
   3.

   Participation in earnings distributions.
   Participation in the proceeds from the sale of the business.
   Sale of interest to another party.

---

7. Which party normally assumes the highest degree of risk?

   a. secured creditor
   b. unsecured creditor
   c. equity investor

---

   c. equity investor

---

8. Which party normally assumes the lowest degree of risk?

a. secured creditor
b. unsecured creditor
c. equity investor

---

a. secured creditor

---

* * * * *

SUMMARY

Objectives

This booklet was developed to teach you about the various sources of capital that are available to the small business owner. The need for additional capital occurs frequently in many small businesses. The ability of the owners to anticipate the need and to know the various money sources available to them will help them secure needed capital on favorable terms.

Internal Sources

Those businesses that are alert to opportunities for internal capital generation will often find that this effort not only minimizes the need for external capital, but also opens the doors of the outside money market to them.

This booklet has explored both internal and external capital sources, showing you how you can minimize your need for external financing through proper asset management and retention of earnings.

External Sources

You have seen how the availability of trade credit can be utilized intelligently in order to maintain favorable supplier relations while taking full advantage of the credit that is available to you from this vital and convenient source.

Various types of loan arrangements were also explored, considering both short- and long-term needs as well as typical requirements for security through pledging of specific assets or the owners' personal guarantees. Finally, the equity capital market was studied so that you understand what the equity investor expects in return for a commitment of capital and the effect that the equity investor's interest can have on your business.

Selecting Money Sources

With this information, you are now prepared to complete the booklet Evaluating Money Sources. That booklet will help you understand the advantages and disadvantages of various capital sources. This will help you select the source, or combination of sources, that is most appropriate for your needs.

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